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OFFICE OF SECRETARY

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February 19, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, NW Room 222
Washington, DC 20554

Re: EX PARTE - (CC Docket No. 96-262) - Access Charge Reform
and (CC Docket 94-1) - Price Cap Performance Review for Local
Exchange Carriers

Dear Mr. Caton:

Today, P. Malandrakis, F. Hedemark, B. Cox and I, representing AT&T, met with R. Cameron, C. Fox; B. Garrett, P. Glenchur, R. Lerner, M. Seifert, D. Sloten, K. Schroder, S. Spaeth, and B. Wimmer, all of the Federal Communications Commission's Competitive Pricing Division regarding the above referenced dockets. The attached material was discussed.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Brian W. Masterson

Attachment

CC:	R. Cameron	C. Fox
	B. Garrett	P. Glenchur
	R. Lerner	M. Seifert
	D. Sloten	K. Schroder
	S. Spaeth	B. Wimmer



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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

**Inappropriate End User
Retail Expense
in
Interstate Switched
Carrier Access**

Inappropriate End User
Retail Expense in Interstate
Switched Carrier Access
(\$ in millions)

Direct Retail Expenses	576.6
Indirect Retail Expenses	<u>263.6</u>
Total	\$840.2

Inappropriate End User Retail Expenses in Carrier Interstate Access

Not a new issue

CC Docket No. 86-297 Recommended Decision and Order From the Federal/State Joint Board Regarding Conformance of Part 36 with Part 32, Released April 8, 1987:

- We also recommend that current billings, the allocator factor for marketing expenses, exclude carriers' access revenues.
- The inclusion of access revenues in the allocation factor for marketing expenses is not a reasonable method of allocation.
- Exchange carriers do not actively market or advertise access services.
- (No rule changes were made.)

Rule Changes Are Needed

- Telcom Act of 1996
- Implement Local Competition
(Docket 96-98)
- Access Reform (Docket 96-262)

Telecommunications Act Of 1996

Sec. 252 (d)(3) Wholesale Prices for Telecommunications Services:

For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

CC Docket No. 96-98

We agree.....that some indirect or shared costs are avoidable and likely to be avoided when a LEC provides retail services to a reseller instead of to the end user. This is because indirect or shared costs, such as general overheads, support all of a LECs functions, including marketing, sales, billing and collection, and other avoided retail functions. Therefore, a portion of indirect costs must be considered "attributable to costs that will be avoided" pursuant to section 252(d)(3).

All costs recorded in accounts 6611 (product management), 6612 (sales), 6613 (product advertising) and 6623 (customer services) are presumed to be avoidable. The costs in these accounts are the direct costs of serving customers.

General support expenses (accounts 6121-6124), corporate operations expenses (accounts 6711, 6712, 6721-28), and telecommunications uncollectibles (account 5301) are presumed to be avoided in proportion to the avoided expenses identified in the previous paragraph.

Inappropriate End User Retail Expenses in Interstate Carrier Access

...Affidavit of Messrs. Fischer, Halprin, Rivera, and Weatherly:

On reconsideration, the FCC decided to include access revenues in the allocation factor for marketing expenses as an interim measure pending the outcome of a further inquiry by the Joint Board. The net effect of this change was to allocate about 26 percent of the LEC's total marketing expenses to the interstate jurisdiction. This is a significant allocator, inasmuch as **the LECs spend far less on marketing of interstate access service, relative to their interstate revenues, than they spend on marketing their intrastate services.**

...SBC Comments in CC Docket No. 96-262

Currently, approximately \$100 million of marketing-related costs are allocated to interstate services based on an analysis of billed revenues, including interstate access revenues. This methodology has resulted in a significant allocation of marketing expense to the interstate jurisdiction. **SWBT proposes to reduce access prices to recognize a more reasoned interstate approach to the recovery of marketing expense. This will result in cost reductions in interstate special access, local switching and transport that should be reflected in reduced prices.**

...New York DPS Comments in CC Docket No. 96-262

Changes in the competitive environment and industry structure may also produce cost savings, which should be fully recognized in lower access charges. **For example, retail costs allocated to the interstate jurisdiction may be avoided when competitors resell the incumbents' services.**

Inappropriate End-User Retail Expense in Carrier Access

- Identified the direct and indirect retail expense allocated to interstate switched access according to the First Report & Order - CC Docket 96-98 (para.917-918).
- Calculated the indirect retail expense allocator:
$$\text{Inappropriate Direct Expense} / \text{Big 3 Expense}$$
- Computed the total inappropriate direct and indirect retail expense included in interstate switched access.

Inappropriate Direct Retail Expense in Access

6611 Product Management

6612 Sales

6613 Product Advertising

6623 Customer Services*

* With the exception of certain Interexchange
Carrier expenses.

Inappropriate Indirect Retail Expense in Access*

General Support Expenses

6121 Land & Building
Expenses
6122 Furniture &
Artwork Exp
6123 Office Equipment
Expense
6124 General Purpose
Computer
Expense

Uncollectible Revenue

5301
Telecommunications
Uncollectibles

****Indirect allocator :***
Inappropriate

Direct Retail Expense /
Big 3 Expense

Executive & Planning/General Administration

6711 Executive
6712 Planning
6721 Accounting &
Finance
6722 External Relations
6723 Human Resources
6724 Information
Management
6725 Legal
6726 Procurement
6727 Research &
Development
6728 Other General &
Admin.

Data Sources

The Automated Report Management Information System 1995 (*ARMIS*) reports.

- **ARMIS 43-04 (Access Report)** This report provides regulated financial and operating data that is separated between state and interstate jurisdictions in accordance with *Part 36*. The interstate data is further allocated to tariff access elements pursuant to *Part 69* of the FCC's rules.
- **ARMIS 43-03 (Joint Cost Report)** This report provides the regulated annual operating results for every account in the Commission's Part 32 Uniform System of Accounts. These data are used to supplement the data from ARMIS 43-04.

Inappropriate Retail Expense in Interstate Switched Carrier Access

Overview

This expense analysis identifies and quantifies inappropriate retail expenses which are embedded in current interstate switched access rates. It has been designed to apply the requirements of Section 252(d)(3) of the Telecommunications Act of 1996, in conjunction with the criteria for cost studies outlined in the First Report and Order in CC Docket 96-98, to interstate access.¹

The Act states that wholesale rates will be determined "on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."² Interstate access is a wholesale service and the retail expenses identified in this study are not associated with the provision of interstate access. Current interstate access is therefore implicitly cross-subsidizing other services in violation of the Act.

The analysis derives the inappropriate retail expense in interstate switched access utilizing data from 1995 Automated Report Management Information System (ARMIS) reports, specifically the ARMIS 43-03 and the 43-04 financial reports, submitted to the Commission by each ILEC. It identifies the functions that are not applicable to the provision of interstate switched access, determines the amount of inappropriate retail costs currently included in access and then removes those amounts, in the manner specified in the 96-98 Order.

Direct Expenses

The costs recorded in the following Uniform System of Accounts (USOA) are inappropriately being recovered through access rates:⁴

6611 - 6613 *Marketing Expense*

6611 - Product Management

6612 - Sales

6613 - Product Advertising

6623 *Customer Service Expense*

6623 - Customer Services

¹ CC Docket 96-98, First Report and Order, FCC 96-325, released August 8, 1996, paras. 917-918.

² 47 U.S.C. Section 252(d)(3).

³ 47 U.S.C. Section 254(k).

⁴ CC Docket 96-98, First Report and Order, FCC 96-325, released August 8, 1996, para. 917.

As an exception to the categories outlined by the Commission, the following subcategories of customer service were identified as applicable to the provision of access, and therefore *not deducted as inappropriate*:

- 6621 - Call Completion Services
- 6622 - Number Services
- 7150 - Total IXC Service Order Processing
- 7170 - Total IXC Payment and Collection
- 7190 - Total IXC Billing Inquiry
- 7270 - Carrier Access

Indirect Expenses

The costs recorded in the following accounts are also inappropriate for recovery through access rates and are removed in proportion to the inappropriate direct expenses identified above:⁵

- 6121 - 6124 ***General Support Expenses -***
 - 6121 - Land & Building Expenses
 - 6122 - Furniture & Artwork Expenses
 - 6123 - Office Equipment Expenses
 - 6124 - General Purpose Computer Expense

- 6711 - 6712 ***Corporate Operations Expenses***

- 6721 - 6728
 - 6711 - Executive
 - 6712 - Planning
 - 6721 - Accounting & Finance
 - 6722 - External Relations
 - 6723 - Human Resources
 - 6724 - Information Management
 - 6725 - Legal
 - 6726 - Procurement
 - 6727 - Research & Development
 - 6728 - Other General & Administration

- 5301 - ***Uncollectible Revenue -***
 - Telecommunications

⁵ Id. at para. 918.

To determine the proportion of indirect expense to be removed from access an indirect allocation factor was calculated consistent with the Commission's criteria⁶:

Inappropriate Direct Retail Expenses/ Big 3 Expense

Big Three Expenses are the combined expense groups comprising:
Plant Specific Operations expense; Plant Nonspecific Operations expense; and Customer Operations expense.

INPUT DATA

The input data used to derive the retail expense in interstate switched access are from the 1995 ARMIS reports that ILECs file annually with the FCC. The analysis uses two data sources from ARMIS:

~ **ARMIS 43-04 (Access Report)** This report provides regulated financial and operating data that are separated between state and interstate jurisdictions in accordance with Part 36. The interstate data is further allocated to tariff access elements pursuant to Part 69 of the FCC's rules.

~ **ARMIS 43-03 (Joint Cost Report)** This report provides the regulated annual operating results for every account in the Commission's Part 32 Uniform System of Accounts. These data are used to supplement the data from ARMIS 43-04.

⁶ Indirect expenses are "presumed to be avoided in proportion to the avoided direct expenses."

**ARMIS Account Information
for
Inappropriate Retail Expense in Access**

Direct Expenses:

The costs recorded in the following Uniform System of Accounts (USOA) are inappropriate:⁷

6610 Marketing Expense

6611 - Product Management

6612 - Sales

6613 - Product Advertising

Account 6610 - *Marketing* is the summary account for accounts 6611 through 6613.

Account 6610 is part of the group of expenses referred to as
Customer Operations Expense.

Account 6611 - Product Management includes costs incurred in performing activities related to marketing products and services. Activities related to competitive analysis, product and service identification and specification, test-market planning, demand forecasting, product life cycle analysis, pricing analysis, and identification and establishment of distribution channels are booked to this account.

Account 6612 - Sales includes costs incurred in selling products and services. Included in this account are expenses related to the determination of individual customer needs, development and presentation of sales records.

Account 6613 - Product Advertising includes costs incurred in developing and implementing promotional strategies to stimulate the purchase of products and services.

6620 Customer Service Expense

6623 - Customer Services

Account 6623 - Customer Services includes costs incurred in establishing and servicing customer accounts. This includes: initiating customer service orders and records; maintaining and billing customer accounts; collecting and investigating customer accounts; collecting and reporting pay station receipts; and instructing customers in the use of products and services.

⁷ CC Docket 96-98, First Report and Order, FCC 96-325, released August 8, 1996, para. 917.

Indirect Expenses :

The costs recorded in the following accounts are also inappropriate for recovery through access rates and are removed in proportion to the inappropriate direct expenses identified above:⁸

6120 General Support Expenses

- 6121 - Land & Building Expenses
- 6122 - Furniture & Artwork Expenses
- 6123 - Office Equipment Expenses
- 6124 - General Purpose Computer Expense

Account 6120 - General Support Expense is the summary account for accounts 6121 through 6124.

Account 6121 - Land and Building expense includes janitorial service, cleaning supplies, water, sewage fuel and guard service, and electrical power.

Account 6122 - Furniture and Artwork expense includes expenses associated with furniture and artworks.

Account 6123 - Office Equipment expense includes only the costs incurred in connection with the office equipment itself. The costs of operators of this equipment are charged to accounts appropriate for the activities performed.

Account 6124 - General Purpose Computers includes costs of personnel whose principal job is the physical operation of general purpose computers and the maintenance of operating systems. Separately metered electricity for general purpose computers is included in this account.

6710 & 6720 Corporate Operations Expenses

- 6711 - Executive
- 6712 - Planning
- 6721 - Accounting & Finance
- 6722 - External Relations .
- 6723 - Human Resources
- 6724 - Information Management
- 6725 - Legal
- 6726 - Procurement
- 6727 - Research & Development
- 6728 - Other General & Administration

Account 6710 - Executive and Planning is the summary account for accounts 6711 through 6712.

⁸ Id. at para. 918.

Account 6711 - Executive includes costs incurred in formulating corporate policy and in providing overall administration and management. Included are the pay, fees, and expenses of boards of directors or similar policy boards and all board-designated officers of the company and their office staffs, e.g., secretaries and staff assistants.

Account 6712 - Planning includes costs incurred in developing and evaluating long-term courses of action for the future operations of the company. This includes performing corporate organization and integrated long-range planning, including management studies, options and contingency plans and economic strategic analysis.

Account 6720 - General and Administrative is the summary account for accounts 6721 through 6728.

Account 6721 - Accounting and Finance includes costs incurred in providing accounting and financial services. Accounting services include payroll and disbursements, property accounting, capital recovery, regulatory accounting, non-customer billing, tax accounting, internal and external auditing, capital and operating budget analysis and control, and general accounting. Financial services include banking operations, cash management, securities management, and debt trust administration, corporate financial planning and analysis, and internal cashier services.

Account 6722 - External Relations includes costs incurred in maintaining relations with government, regulators, other companies and the general public. This includes reviewing existing or pending legislation; preparing and presenting information for regulatory purposes including tariff and service cost filings, obtaining radio licenses and construction permits; performing public relations and non-product related corporate image advertising activities; administering relations, including negotiating contracts with telecommunications companies and other utilities, businesses and industries; and administering investor relations.

Account 6723 - Human Resources includes costs incurred in performing personnel administration activities. This includes: equal employment and affirmative action programs; employee data for forecasting, planning and reporting; general employment services; occupational medical services; labor relations activities; personnel development and staffing services; personnel policy development; employee communications; benefit administration; and employee activity and safety programs.

Account 6724 - Information Management includes costs incurred in planning, developing, testing, implementing and maintaining data bases and application systems for general purpose computers.

Account 6725 - Legal includes costs incurred in providing legal services. This includes conducting and coordinating litigation, providing guidance on regulatory and labor matters, preparing, reviewing and filing patents and contracts and interpreting legislation.

Account 6726 - Procurement includes costs incurred in procuring material and supplies, including office supplies. This includes analyzing and evaluating suppliers' products, selecting appropriate supplies, negotiating supply contracts, placing purchase orders, expediting and controlling orders placed for material..

Account 6727 - Research and Development includes costs incurred in making planned search or critical investigation aimed at discovery of new knowledge. It also includes translating research findings into a plan or design for a new product or process or for a significant improvement to an existing product, process, whether intended for sale or not.

Account 6728 - Other General and Administrative includes activities not directly charged to the user, and not provided for in other accounts. This includes costs incurred in providing reference libraries, food services, archives, general security investigation services, operating official private branch exchanges in the conduct of business, and telecommunications and mail services.

5301 *Uncollectible Revenue - Telecommunications*

Account 5301 - Uncollectible Revenue - Telecommunications is charged with amounts concurrently credited to Account 1181, Accounts Receivable Allowances - Telecommunications to provide for uncollectible amounts.

Information Source: 47 C.F.R. Part 32 (1995).

**Inappropriate Retail Expenses in
Interstate Carrier Switched Access
All ARMIS Reporting Companies
(\$ in thousands)**

Direct Expenses			A	B	C	D
			Total Common Line (ARMIS input)	Carrier Common Line (Col A - SLC **)	Traffic Sensitive (ARMIS input)	Interexchange Carrier Access (Col B +C)
ArmIs 4304						
Line	Account					
7000	*6610	Marketing Expense	\$463,727	\$162,987	\$259,722	\$422,709
	6611	Product Management				
	6612	Sales				
	6613	Product Advertising				
##7320	*6620	Customer Service Expense	\$340,930	\$119,827	\$121,490	\$241,317
	6623	Customer Services				
Subtotal Retail Direct Expenses						\$664,026
The following ARMIS 6620 subcategories are still applicable for the provision of interstate access....						
7270		Carrier Access				\$11,512
7148 & 7149		Tot IC Svc Ord				\$32,862
7168 & 7169		Tot IC Pay & Col				\$36,133
7188 & 7189		Tot IC Bill Inq				\$6,923
Subtotal of the Accts to be deducted from inappropriate expenses						\$87,430
Total Inappropriate Direct Retail Expenses						\$676,596

Indirect Expenses			A Total Common Line (ARMIS input)	B Carrier Common Line (Col A - SLC **)	C Traffic Sensitive (ARMIS input)	D Interexchange Carrier Access (Col B + C)
5010	*6120	General Support Expenses	\$631,194	\$221,847	\$351,969	\$573,816
		6121 Land & Building Expense				
		6122 Furniture and Artwork Expense				
		6123 Office Equipment Expense				
		6124 General Purpose Computer Expense				
		Corporate Operations Expense				
7334	*6710 & 6720	Executive & Planning / Gen Admin	\$1,211,932	\$425,960	\$672,979	\$1,098,939
		6711 Executive				
		6712 Planning				
		6721 Accounting and Finance				
		6722 External Relations				
		6723 Human Resources				
		6724 Information Management				
		6725 Legal				
		6726 Procurement				
		6727 Research and Development				
		6728 Other General and Administrative				
4040	*5300	Uncollectible Revenue	\$73,931	\$25,985	\$22,734	\$48,719
	5301	#Telecommunications Uncollectibles				
		Total Indirect Expenses				\$1,721,475
7333		Indirect Allocator				15.3%
		(Total Direct Retail Expense / Big 3 Exp)				
Total Inappropriate Indirect Retail Expenses						\$263,843
(Indirect Expense * Indirect Allocator)						
Total Inappropriate Direct & Indirect Retail Expenses						\$840,239

*Information source - ARMIS 43-04 & 43-03 1995 reports(\$ in thousands)

Account 7320 (Cust Svc Exp) contains Account 7000 (Mktg) expenses.

To eliminate duplication, Account 7000's expenses were deducted from Account 7320.

ARMIS account 5300 contains other uncollectible revenue in addition to the telecommunications uncollectibles, therefore, we removed the other uncollectible revenue. (tele uncoll = 97% of total uncollectibles)

**SLC allocator was calculated as follows: (SLC = 64.9% of total CL)

Source: ARMIS 43-04

ii 4010 eu36 6,914,840

ii 4014 tot cl 10,662,362

1-(ratio4010/4014) 35.1%

**Inappropriate General
Support Facilities Expense
In Interstate Access***

***These expenses support nonregulated
Billing & Collection services.**

Inappropriate General
Support Facilities
Expense In Interstate Access
(\$ in millions)

General Support Expense	61.6
GSF Depr. & Amort. Exp.	33.3
Return on GSF Net Inv.	<u>29.0</u>
Total	\$123.9

**PROBLEM CREATED DURING THE CONFORMANCE OF SEPARATIONS
AND ACCESS ALLOCATION RULES TO THE NEW PART 32 USOA RULES
(CC Docket No. 87-113)**

Old Parts 31/67/ 69 Allocation

Revenue Accounting Expense	Functional Analysis	\$ Allocated to B&C
Land, Building, Computer, Ofc. Eq. (Incl. related expenses)	Functional Analysis	\$ Allocated to B&C

Current Parts 32/36/69 Allocation

General Purpose Computer Exp.	Network Plant *	Nothing to B&C
Customer Services Expense	Directly Assigned	\$ Allocated to B&C
Information/Management Exp.	Big 3 Expense Ratio	\$ Allocated to B&C
General Support Facilities (Incl. related expenses)	Network Plant *	Nothing to B&C

*Change allocator to
Big 3 Expense Ratio

Inappropriate General Support Facilities Expense In Interstate Access

- Developed a Billing & Collection/Total Interstate "Big Three Expense Ratio" (ARMIS 43-04)
- Applied B&C Big Three Expense Ratio to GSF related Accounts
- Computed Total Expenses That Support B&C Services that are Currently in Interstate Access